JUN 8 2001

Supreme Court, U.S.
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CLERK

Nos. 00-511, 00-555, 00-587, 00-590 & 00-602

IN THE

Supreme Court of the United States

FEDERAL COMMUNICATIONS COMMISSION, *et al.*,
Petitioners,

v.

IOWA UTILITIES BOARD, *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF FOR RESPONDENT QWEST COMMUNICATIONS INTERNATIONAL, INC.

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June 8, 2001

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QUESTION PRESENTED

Whether an FCC rule concerning the rates an incumbent local telephone company may charge competitors for sharing its facilities is contrary to the Telecommunications Act of 1996 and arbitrary and capricious because the rule ignores the incumbent's real-world network and costs and instead sets rates based on an estimate of the costs that a hypothetical carrier would incur if it built and rebuilt a new ideal network using the least-cost, most efficient available technologies.

CORPORATE DISCLOSURE STATEMENT

Pursuant to Supreme Court Rule 29.6, respondent Qwest Communications International, Inc. states as follows:

Respondent Qwest Communications International, Inc. is a publicly held corporation that has no parent company. Through its operating subsidiaries, Qwest Communications International, Inc. provides broadband Internet-based data, voice, and image communications for business and consumers. No publicly held company owns ten percent or more of Qwest Communications International, Inc. stock.

U S WEST, Inc. merged with and into Respondent Qwest Communications International, Inc. on June 30, 2000. U S WEST, Inc. was formerly the parent and sole shareholder of U S WEST Communications, Inc. U S WEST Communications, Inc. was renamed Qwest Corporation on July 6, 2000. Qwest Corporation is a wholly owned subsidiary of Qwest Communications International, Inc. Qwest Corporation is a local exchange carrier that provides local exchange telecommunications, exchange access, information access, data services, wireless services, and intraLATA long distance services pursuant to tariff and contract.

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OPINION BELOW

The opinion of the United States Court of Appeals is reported at 219 F.3d 744 and reprinted at pages 1a-43a of the Petitioner's Appendix in No. 00-511 ("Pet. App."). That opinion reviewed and vacated portions of the Federal Communications Commission's First Report and Order, *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Dkt. No. 96-98 (rel. Aug. 8, 1996) (the "order"), and accompanying regulations. The order is reported at 11 FCC Rcd 15,499 and reprinted in relevant part at J.A. 264-452.

JURISDICTION

The judgment of the court of appeals was entered on July 18, 2000. The government filed its petition for a writ of certiorari in No. 00-587 on November 29, 2000. This Court granted that petition, and related petitions, on January 22, 2001, and has jurisdiction pursuant to 28 U.S.C. § 1254(1).

PERTINENT STATUTORY PROVISIONS

This case involves sections 251 and 252 of the Telecommunications Act of 1996, 47 U.S.C. §§ 251, 252, section 706 of the Administrative Procedure Act, 5 U.S.C. § 706, and Federal Communications Commission regulations codified at 47 C.F.R. §§ 51.501-51.511. These provisions are reprinted at Pet. App. 152a-177a.

STATEMENT OF THE CASE

This case concerns an issue that is central to the goal of the Telecommunications Act of 1996 ("1996 Act") to create real competition in the local telephone market: what prices incumbent local exchange carriers ("incumbents" or "ILECs") may charge when they are required to share their facilities with new competitive local exchange carriers ("CLECs"). Congress directed that these prices be based on the cost of providing the facility involved. The FCC, how-

ever, determined that these prices should be based on the totally theoretical cost of a newly constructed, idealized network that "use[s] the most efficient telecommunications technology currently available and the lowest cost network configuration." 47 C.F.R. § 51.505(b)(1). The United States Court of Appeals for the Eighth Circuit vacated this pricing rule. That decision should be affirmed.

By passing the 1996 Act, Congress signaled its desire to foster, on a nationwide basis, what technological developments now permit: real competition between local telephone service providers. Congress specifically sought to encourage rival competitors to deploy alternative network facilities. At the same time, it recognized that, at least in the short term, new entrants would not be able to construct ubiquitous networks. Accordingly, Congress enabled entrants to lease individual pieces of the incumbents' facilities, called unbundled network elements or UNEs. Congress required that the prices for such UNEs be based on "the cost . . . of providing the . . . network element," 47 U.S.C. § 252(d)(1), and it charged the Federal Communications Commission ("FCC") with devising guidelines by which state public utility commissions would determine UNE prices.

The FCC adopted a forward-looking pricing methodology that it called TELRIC — short for total element long run incremental cost. That methodology does not attempt to determine the forward-looking costs that an *ILEC* will incur in providing an element. Rather, with a single unexplained exception, the FCC's methodology ignores altogether the ILEC's existing network and the iterative process by which an actual network is built. In its place, the methodology attempts to estimate the costs that a hypothetical carrier would incur if, each time a CLEC seeks to purchase a UNE, the hypothetical carrier instantaneously constructed an entirely new network using the least-cost, most-efficient available technologies and network configuration.

As the court of appeals held, while the FCC has discretion to determine the cost of providing an element using forward-looking costs, the 1996 Act does *not* give the agency authority to ignore altogether the ILEC's costs of providing an element. The FCC's mandate of the TELRIC methodology accordingly was a fatally flawed implementation of the Act. Whatever its role as a theoretical economic construct, TELRIC as applied by the FCC is so extreme that it significantly undermines the very purposes of the Act. In relying on such a methodology, the FCC thwarted the development of the real-world competitive process that Congress intended to permit, and instead created a marketplace distorted by artificial regulatory incentives concerning investment and entry. The FCC's TELRIC methodology cripples the incentives of CLECs and ILECs to invest in competitive facilities, and, contrary to the FCC's claim, fails to reflect how real-world markets operate. The court of appeals properly recognized that TELRIC therefore is directly contrary to Congress's intent, and that court's decision to vacate the portion of the FCC's rules that bases prices on a hypothetical, ideally efficient network should be affirmed.

A. The Telecommunications Act of 1996

The 1996 Act marked Congress's rejection of the premise that local telephone service is a natural monopoly. *See AT&T v. Iowa Utils. Bd.*, 525 U.S. 366, 371 (1999). Congress instead embraced the notion that technological advances have made local service competition possible. *See id.*; H.R. Conf. Rep. No. 104-458, at 113, 148 (1996) ("Conf. Rep."). It sought broadly to encourage that competition and the rollout of new advanced technologies in all telecommunications sectors and in all regions. *See* Conf. Rep. at 113. To achieve this objective, Congress ended the monopoly franchises previously granted by the states, preempting any state or local law that "may prohibit or have the effect of prohibiting the ability of any entity to provide any interstate or intrastate telecommunications service." 47 U.S.C. § 253(a).

Congress recognized that, at least in the near term, new entrants in the local telephone market may be unable to deploy ubiquitous network facilities. *See* Conf. Rep. at 148. As a result, the Act provides three distinct routes by which a carrier can begin to offer competing local service without deploying a complete network. First, any carrier may, on request, interconnect its network facilities with the facilities of an incumbent LEC, allowing customers of different carriers seamlessly to call each other. *See* 47 U.S.C. § 251(c)(2). Second, CLECs may obtain access to selected pieces of the incumbent's network as unbundled network elements "at any technically feasible point . . . in a manner that allows requesting carriers to combine such elements in order to provide . . . telecommunications service." *Id.* § 251(c)(3). Third, CLECs may buy complete services from the incumbent at wholesale prices and resell those services. *See id.* § 251(c)(4).

The legislative history of the Act confirms that Congress believed that "meaningful facilities-based competition is possible." *See, e.g.*, Conf. Rep. at 148. It confirms, too, what the logic of the Act and basic economics suggest: Congress intended to encourage facilities-based competition no less than competition using UNEs or service resale. Congress sought "to provide . . . a pro-competitive, de-regulatory national policy framework designed to *accelerate . . . deployment of advanced telecommunications and information technologies* . . . by opening all telecommunications markets to competition." *Id.* at 113 (emphasis added); *id.* at 1 (the Act was intended to "accelerate rapidly private sector deployment of advanced telecommunications and information technologies"). Thus, any interpretation that prefers competition by means of UNEs or resold services over facilities-based competition is a serious misreading of the Act.

Indeed, the Act places limits on the availability and pricing of UNEs precisely to ensure that CLECs' rights to use UNEs will not be so broad as to stifle the CLECs' incentives to deploy facilities of their own (or to stifle incentives for

ILECs to invest in new facilities). *See, e.g., Iowa Utils. Bd.*, 525 U.S. at 387-92 (relevant language "requires the FCC to apply *some* limiting standard, rationally related to the goals of the Act"). Not every network facility must be unbundled and provided to competing carriers. Congress charged the FCC with "determining what network elements should be made available." 47 U.S.C. § 251(d)(2). In fulfilling that charge,

> the Commission shall consider, at a minimum, whether—
>
> (A) access to such network elements as are proprietary in nature is *necessary*; and
> (B) the failure to provide access to such network elements would *impair* the ability of the telecommunications carrier seeking access to provide the services that it seeks to offer.

Id. (emphasis added). This mandate has come to be referred to as the "necessary and impair standard."

For UNE pricing, Congress relied first on incumbents and new entrants to negotiate prices in the context of broader interconnection agreements. *See id.* § 252(a). The statute allows carriers to bargain "without regard" to the Act's requirements, including the provision concerning pricing of UNEs. *Id.* §§ 251(c)(1), 252(a)(1), 252(e)(2)(A). Only if the parties cannot reach agreement may state commissions set UNE prices through arbitration proceedings. *See id.* § 252(b). Such UNE prices must be "based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the . . . network element," must be "just and reasonable," and "may include a reasonable profit." *Id.* § 252(d)(1).

B. The FCC's Notice of Proposed Rulemaking

On April 19, 1996, the FCC released a notice of proposed rulemaking to implement the local competition provi-

sions of the Act. *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, Notice of Proposed Rulemaking, 11 FCC Rcd 14,171 (re. Apr. 19, 1996). The FCC posited that the UNE pricing provisions of the Act "appear[] to contemplate the use of . . . forms of cost-based price regulation, such as . . . the setting of prices based on a forward-looking cost methodology that does not involve the use of an embedded rate base, such as long-run incremental cost (LRIC)." *Id.* ¶ 123. It pointed to some state laws as examples of the model that it contemplated, *id.* ¶ 127, including a Michigan law requiring that the "[t]echnology used in a long-run incremental cost study should be the least-cost, most efficient technology that is currently available for purchase." *See* Michigan Public Service Commission, *Re A Methodology to Determine Long Run Incremental Cost*, 156 P.U.R.4th 1 (1994), Exhibit A. Under this principle, "the selection of the least cost technology is not based on the economics of adding to the current stock of telecommunications equipment providing service today, but rather assumes no equipment is currently in service and a completely new network is to be installed." *Id.* (internal quotations omitted).

Many commenters objected to the use of the pricing methodology contemplated by the FCC. They submitted testimony by economists such as Alfred Kahn and Timothy Tardiff, who challenged the premise "that the proper basis for the pricing of LEC services sold to competitors . . . is the . . . the total forward-looking cost of a hypothetical, ideally efficient system built by either the incumbent or some other carrier starting with a blank slate, using the most efficient current technology." Bell Atlantic Reply Comments, Kahn & Tardiff Decl. ¶ 8, CC Dkt. No. 96-98 (May 30, 1996). Kahn and Tardiff rejected the view that a "blank-slate" approach would mimic "the level to which competition would drive prices. . . . In a world of continuous technological progress, it would be irrational for firms constantly to update their facilities in order *completely* to incorporate today's lowest-cost technology, as though starting from scratch: investments

made today . . . would instantaneously be outdated tomorrow and, in consequence, never earn a return sufficient to justify the investments in the first place." *Id.* Kahn and Tardiff concluded that fostering the development of a real competitive marketplace requires that entrants be allowed to compete against the *ILEC's* costs, not those of a hypothetical, most efficient firm: "considerations of economic efficiency *require* that the prices charged to competitors be based upon the LECs' *actual* costs; to the extent competitors can provide these inputs more efficiently than the LECs, this will fully preserve their incentive to do so and thereby promote efficient facilities-based entry."[1] *Id.* (emphasis in original).

C. The FCC's Local Competition Order

The FCC released the order on review on August 8, 1996. In addressing which facilities ILECs must unbundle as UNEs, the order read the Act to "impose[] on an incumbent LEC the duty to provide *all* network elements for which it is *technically feasible* to provide access on an unbundled basis." J.A. 288, 292-93 (Order ¶¶ 278, 286-87) (emphasis added). The FCC "decline[d] to adopt" the view that the

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[1] Other economic witnesses voiced similar concerns about the FCC's proposed model. As one noted, using such a model would guarantee that ILECs were always compensated at less than *their* forward-looking costs because, "[e]ven if actual . . . investment decisions were always completely efficient at the time they were made, improvements in technology will *always* guarantee that a totally new, hypothetical, network will have a theoretical lower cost than the actual network in place (or otherwise the older technology could be used in the hypothetical network)." GTE Comments, Hausman Aff. ¶ 14 n.4, CC Dkt. No. 96-98 (May 16, 1996) (emphasis in original); *see also id.* ¶ 3 ("Technological change will deprive LECs of recovering costs if rates are always measured on the basis of a forward-looking optimal network model."); GTE Comments, Crandall Decl. ¶¶ 15-16, CC Dkt. No. 96-98 (May 16, 1996) ("There are simply no market analogues for [the FCC's proposed model]. . . . Unfortunately, there is simply no evidence that such hypothetical networks would represent an efficient use of society's resources. If this were not the case, *someone would be building them.*") (emphasis in original).

necessary and impair standard requires it to consider whether a new entrant could obtain the requested element from a source other than the incumbent. *Id.* at 296-97, 299-300 (Order ¶¶ 283, 287). The order declared that *any* increase in cost or decrease in quality, no matter how trivial, would satisfy the impairment standard, on the ground that "requiring new entrants to duplicate unnecessarily *even a part of the incumbent's network* could generate delay and higher costs for new entrants, and thereby impede entry by competing local providers and delay competition, contrary to the goals of the 1996 Act." *Id.* at 296-97, 298 (Order ¶¶ 283, 285) (emphasis added). "The 1996 Act . . . does not impose *any* limitations on carriers' ability to obtain access to unbundled network elements." *Id.* at 312-13 (Order ¶ 329) (emphasis added).

The order then turned to the pricing of UNEs. It adhered to the FCC's proposal to base UNE rates on the theoretical forward-looking costs of an idealized hypothetical competitor. *See* J.A. 375-76, 397-401 (Order ¶¶ 672-73, 704-07). Notwithstanding the criticisms voiced in the comments, the agency essentially adopted the same model it had proposed. The FCC "coin[ed]" a new term, Total Element Long-Run Incremental Cost ("TELRIC"), for a model that purported to gauge the LRIC of network *elements*, rather than *services*.[2] *See id.* at 378-79 (Order ¶ 678).

The TELRIC methodology is expressly based on the "use of the most efficient telecommunications technology currently available and the lowest cost network configuration." 47 C.F.R. § 51.505(b)(1); *see also* J.A. 382-84, 386-87 (Order ¶¶ 683-85, 690). In other words, by imagining a period "long enough so that all of a firm's costs become variable or avoidable," *id.* at 387, 397 (Order ¶¶ 677, 692), the model seeks to determine what a most efficient, least-cost network would look like if it were reconstructed from scratch at the time when UNE prices are being set, and then hypothesizing what the costs of that network would be. *See Iowa Utils. Bd.*, 525 U.S. at 374 n.3 ("TELRIC pricing is based upon the cost of operating a hypothetical network built with the most efficient technology available"). UNE prices are to reflect this idealized network's imagined costs.

[2] The FCC made this change on the assumption that elements are likely to have fewer joint and common costs than services. *See.* J.A.378-79 (Order ¶ 678). The order nevertheless acknowledges that incumbents still will have joint and common costs and that states may permit such costs to be recovered in UNE prices. *See id.* at 389-90 (Order ¶ 695).

The FCC acknowledged that a TELRIC methodology would "discourage facilities-based competition by new entrants because new entrants can use the incumbent LEC's existing network based on the cost of a hypothetical least-cost, most efficient network" and therefore would have sharply reduced incentives to build their own facilities. J.A. 382-83 (Order ¶ 683). The FCC's only palliative was to allow the inclusion of one real-world factor: regulators would "assume that wire centers will be placed at the incumbent LEC's current wire center locations."[3] *Id.* at 383-84 (Order ¶ 685). The FCC's methodology ignores the actual location of all the other facilities in an ILEC's network and instead reconstructs the network based on the theoretically ideal locations for such facilities. The FCC said that its consideration of actual wire center locations would "encourage[] facilities-based competition to the extent that new entrants, by designing more efficient network configurations, are able to provide the service at a lower cost than the incumbent LEC." *Id.* The FCC did *not* explain why the same rationale does not apply to the locations of ILEC network facilities other than wire centers — that is, why CLECs should be encouraged to invest in facilities only when they can locate wire centers more efficiently than the incumbent has and not when they can locate other parts of the network more efficiently. Nor

[3] A wire center is the physical location where subscriber lines connect to a switch.

did the FCC explain why its rationale does not apply when CLECs could employ more efficient technologies than the incumbent.

The agency did recognize that it *could* have based forward-looking costs "on incumbent LECs' existing network infrastructures, taking into account changes in depreciation and inflation." J.A. 382-83 (Order ¶¶ 683-84). But the agency rejected that approach in a single sentence, labeling it "essentially an embedded cost methodology." *Id.*

D. Subsequent Proceedings

Incumbent LECs and state commissions sought review of the order in the Eighth Circuit. That court held that the FCC lacked jurisdiction to adopt pricing rules, and it accordingly did not reach the merits of those rules. *See Iowa Utils. Bd. v. AT&T*, 120 F.3d 753, 800 (8th Cir. 1997). This Court reversed, holding "that the Commission has jurisdiction to design a pricing methodology." *Iowa Utils. Bd.*, 525 U.S. at 385.

This Court also rejected the FCC's conclusion that the necessary and impair standard imposes no limitations on a carrier's ability to obtain access to unbundled network elements. *See id.* at 387-91. The FCC's error in reading the standard sprang from its mistaken understanding that the Act empowers it to assume the existence of a perfectly competitive market for telecommunications services, an assumption similar to the theoretical perfection that underlies TELRIC. "In a world of perfect competition, in which all carriers are providing their service at marginal cost, the Commission's total equating of increased cost (or decreased quality) with 'necessity' and 'impairment' might be reasonable; *but it has not established the existence of such an ideal world.*" *Id.* at 390 (emphasis added). Congress could have written language authorizing 'blanket access to incumbents' networks," but did not, and the FCC could not make up for the omission

by importing perfect competition assumptions found nowhere in the statute.[4] *Id.*

On remand, the court of appeals for the first time addressed the merits of TELRIC pricing. It upheld the FCC's decision to base prices on forward-looking rather than historical costs and rejected as unripe the takings challenge by ILECs to that decision. *See* Pet. App. 10a-18a. The court agreed with the FCC that the "the term 'cost,' as it is used in the statute [was] ambiguous," and it deferred to the FCC's choice of forward-looking costs. *Id.* at 11a-12a. But the court rejected the FCC's particular forward-looking cost approach. The court concluded that TELRIC, by completely divorcing the prices that an ILEC may charge for UNEs from the ILEC's costs of providing the elements, was directly contrary to the Act. The court ruled that UNE prices must instead be based on an ILEC's *own* forward-looking costs:

> Costs can be forward-looking in that they can be calculated to reflect what it will cost the ILEC in the future to furnish to the competitor those portions or capacities of the ILEC's facilities and equipment that the competitor will use including any system or component upgrading that the ILEC chooses to put in place for its own more efficient use. . . . At bottom . . . Congress has made it clear that it is the cost of providing the actual facilities and equipment that will be used by the competitor (and not some state of the art presently available technology ideally configured but neither deployed by the ILEC nor to be used by the competitor) which must be ascertained and determined.

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[4] The FCC issued a new order interpreting the "necessary and impair" standard on remand. *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, Third Report and Order, 15 FCC Rcd 3696 (rel. Nov. 5, 1999) ("*UNE Remand Order*"). That order is under review yet again in the court of appeals. *See United States Telecom Ass'n v. FCC*, Nos. 00-1015 & 00-1025 (D.C. Cir.).

Id. at 9a-10a.

As a result, while leaving intact much of the FCC's pricing regime, the court of appeals vacated the particular rule requiring that prices be based, not on the ILEC's costs, but on the costs that a hypothetical carrier would incur through "use of the most efficient telecommunications technology currently available and the lowest cost network configuration." *See id.* at 10a (vacating 47 C.F.R. § 51.505(b)(1)).

Several incumbents sought review of the court of appeals' rejection of historical costs. The FCC and a number of CLECs petitioned for certiorari to review the court's decision vacating the agency's rule basing UNE prices on a hypothetical most efficient network. This Court granted certiorari on both sets of pricing issues.[5] Qwest respectfully submits that the decision of the court of appeals to vacate the FCC's pricing rule should be affirmed.

SUMMARY OF ARGUMENT

The FCC's TELRIC methodology is inconsistent with the 1996 Act and arbitrary and capricious. The Act requires that UNE prices be based on the costs that an *ILEC* incurs in "providing" an element. The FCC instead based UNE rates on the costs that a *hypothetical carrier* would incur in using an ideally efficient network that never will exist and that the ILEC never will use to provide any element. Rather than foster the development of an actual competitive process, the FCC's order prescribes prices that correspond to the agency's guess at what the end result might be in a theoretical world of perfect competition and instantaneous deployment of new

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5 The Court also granted the FCC's petition for certiorari to review the lower court's ruling on rules concerning the conditions under which ILECs could be required to combine UNEs. Qwest joins the separate Respondents' brief on that issue. *See* Brief for Respondents Verizon Entities, BellSouth Corp., SBC Communications, Inc., and United States Telecom Association (June 8, 2001).

technologies. This approach could not be more at odds with the language of the Act or its deregulatory purposes. It embodies the same error that this Court found infected the agency's reading of the "necessary and impair" test for unbundling: even if the FCC's reading might be reasonable "[i]n a world of perfect competition . . . it has not established the existence of such an ideal world." *Iowa Utils. Bd.*, 525 U.S. at 390. The FCC's ideal world is divorced from the actual market context in which carriers compete. It lowers *prices* without any corresponding decrease in *costs* and thereby distorts market signals and discourages investment in network facilities, contrary to the goals of the Act.

The FCC's methodology also is arbitrary and capricious on its own terms. The assumptions embodied in TELRIC about how a real-world competitive market works are simply wrong, especially where, as in the telecommunications sector, the market is capital-intensive and characterized by frequent cycles of innovation and declining costs. Carriers do not instantly and ubiquitously replace their network facilities every time a more efficient technology becomes available, nor do they immediately reduce their prices to the incremental costs of the new network. Instead, building a network is an iterative process. A carrier adjusts the capacity and location of network facilities as customer populations shift and grow, and it invests in new facilities only when the gap between prevailing prices and the costs of the new technology becomes sufficiently great to allow the carrier to price between those two levels and expect to earn a return on its investment. The utter failure of TELRIC to mimic the operation of a market explains why the FCC is unable to point to any instance in which such a methodology has been used to set prices in similar circumstances. The end result of the FCC's methodology is to ensure that the incumbent has no chance to recover its costs of providing network elements — a result in direct contravention of the Act.

Contrary to the suggestion by petitioners, rejection of the TELRIC model by no means requires the conclusion that the term "cost" has a "single meaning" or that the FCC lacks discretion in establishing pricing guidelines for UNEs. In place of the one rule vacated by the court of appeals, the FCC could use the "historical cost" model championed by Verizon or a model based in whole or part on forward-looking costs. But the court below properly concluded that the agency does not have discretion to adopt a methodology such as TELRIC that eschews the incumbent's costs altogether in favor of the agency's hypothesis of the costs of a nonexistent network built to serve perfectly estimated demand in the most efficient way conceivable with available technologies. That methodology is contrary to the statutory text and its animating purposes and is arbitrary and capricious.

ARGUMENT

I. TELRIC IS FLATLY INCONSISTENT WITH THE TEXT OF THE STATUTE.

Section 252(d)(1) provides that UNE rates "shall be . . . based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the . . . network element," shall be "just and reasonable," and "may include a reasonable profit." 47 U.S.C. § 252(d)(1). These provisions require that UNE prices be based on the costs that an ILEC will incur in providing a particular element. While the Act does not mandate a single methodology for determining those costs, it *does* limit the FCC's discretion by forging a relationship between the price an ILEC may charge for a UNE and the costs that the *ILEC* incurs in providing the UNE. TELRIC severs that relationship, and links UNE prices instead to the costs that would be incurred by a hypothetical competitor using "the most efficient telecommunications technology currently available and the lowest cost network configuration." 47 C.F.R. § 51.505(b)(1). The Eighth Circuit correctly vacated this rule as inconsistent with the

text of section 252(d)(1), and this Court should affirm. *See, e.g., United States v. Wells*, 519 U.S. 482, 490 (1997) (natural reading of the full text is the "first criterion in the interpretive hierarchy" for statutes); *Connecticut Nat'l Bank v. Germain*, 503 U.S. 249, 253-54 (1992) ("[C]ourts must presume that a legislature says in a statute what it means and means in a statute what it says there.").

Section 252(d)(1) requires that UNE rates be "based on *the cost . . . of providing the* . . . network element." 47 U.S.C. § 252(d)(1) (emphasis added).[6] The FCC and its supporters focus on the term "cost" in isolation and assert that the ambiguity of that term gives the FCC virtually carte blanche discretion. *See* FCC Pet. Br. at 27-28; AT&T Pet. Br. at 29; WorldCom Pet. Br. at 25-26. But even assuming that "cost" itself may have different meanings, this does not imply that the term imposes no constraints at all, and the rest of the words in the statutory directive preclude the FCC's choice of TELRIC. First, by mandating that UNE rates be "based on the cost . . . of *providing*" an element, Congress directed the FCC to choose a methodology that measures the costs that the ILEC — which is doing the providing — incurs in providing elements. TELRIC, by contrast, bases UNE prices on the costs that a hypothetical carrier would theoretically incur in providing the element's functions over an imaginary network that uses only the most efficient technology and network layout available at all times. *See, e.g.*, J.A. 382-84 (Order ¶¶ 683-85). Since those hypothetical costs will never correspond to (and, indeed, will always be lower than) the costs that the ILEC incurs in providing the element, TELRIC does not produce a price "based on the cost . . . of providing" the UNE.

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6 As the FCC has noted, the parenthetical term "determined without reference to a rate-of-return or other rate-based proceeding" does not "define the type of costs that may be considered, but rather specifies a type of proceeding that may not be employed." J.A. 397-98 (Order ¶ 704).

Second, as the court of appeals concluded below, by linking UNE prices to the cost of providing "*the* . . . network element," the statute focuses on the *actual* element or functionality that will be provided. *See* Pet. App. 7a-9a.[7] If Congress had intended UNE rates to reflect the costs of a hypothetical UNE that might be provided by a nonexistent carrier in a market where prices instantly reflect the most efficient technology available, it could have, and would have, used language to that effect. But Congress did not do so, and the FCC is not empowered to treat the statute as though it had.

The legislative history of section 252(d)(1) confirms that Congress intended UNE prices to correspond to the costs of the providing ILEC, not the costs of a hypothetical competitor. The House bill specified a pricing standard "requir[ing] that the costs *that a carrier incurs* in offering . . . unbundled . . . elements . . . shall be borne by the users of such . . . elements." H.R. Rep. No. 104-204, at 4 (1995) (emphasis added). The Senate Report likewise noted that the UNE pricing provision (then enumerated section 251(d)) "provides that any charge determined by the State through arbitration or intervention shall be based on the cost of *that* unbundled element and may include a reasonable profit." S. Rep. No. 104-23, at 21 (1995) (emphasis added). This language reinforces the text of the statute: section 252(d)(1) ties rates for a given element to the costs not of some hypothetical alternative, but of *that* element, in the *actual context* in which the ILEC will provide it. TELRIC ignores this clear congressional mandate.

Congress's intention that UNE prices relate to an ILEC's costs is further corroborated by the terms that Congress used

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[7] This does not mean, as WorldCom suggests, that a unique price must be assigned to every individual switch or loop. *See* WorldCom Pet. Br. at 27-28. A regulator may choose to set a single average price for loops, or for loops within a particular geographic area, but that price must be based on the costs that the incumbent will incur in providing *its* loops.

elsewhere in section 252(d)(1). The statute directs that rates "may include a reasonable profit." Although this language gives regulators some discretion to decide whether or not to include a profit, they could not even *consider* the question unless the ratesetting mechanism took account of the ILEC's actual investments and expenditures. Time and again, courts, economists, and other authorities have construed the term "profit" to refer to the amount by which an entity's returns exceed its costs. *See, e.g.*, *California Dental Ass'n v. FTC*, 526 U.S. 756, 767 n.6 (1999) ("[A]ccording to a generally accepted definition 'profit' means gain from business or investment over and above expenditures, or gain made on business or investment where both receipts or payments are taken into account.") (internal quotations omitted); Steven E. Landsburg, *Price Theory and Applications* 782 (3d ed. 1995) (defining "profit" as "[t]he amount by which revenue exceeds costs"); Black's Law Dictionary 1211 (6th ed. 1990) (defining profit as the "[g]ain realized from business or investment over and above expenditures"). Indeed, the FCC's order here acknowledges that, "in plain English, profit is defined as 'the excess of returns over expenditure in a transaction or series of transactions.'" J.A. 393 (Order ¶ 699).[8]

By directing regulators to consider whether to include a "profit," Congress voiced its expectation that a UNE rate would be set based on an *ILEC*'s costs. TELRIC forecloses any potential for profit by setting UNE prices such that the ILEC has no chance to recoup its costs, even of *future* investments, except at a hypothetical instant at which every

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[8] The FCC attempted to reconcile this definition of profit with its TELRIC standard by stating conclusorily that "[p]ossible accounting losses from the sale of . . . unbundled network elements using a reasonable forward-looking cost-based methodology do not necessarily indicate that incumbent LECs are being denied a 'reasonable profit' under the statute." J.A. 395 (Order ¶ 701). That assertion does not explain how a methodology that disregards everything about an incumbent's actual network can measure the incumbent's costs or, *a fortiori*, its return in excess of costs.

component of its facilities is the most efficient component available. *See, e.g.*, GTE Comments, Hausman Aff. ¶ 14. As discussed more fully below, *see* Part III, *infra*, that instant never will arrive in practice for any ILEC; and if it did, prices and costs would immediately diverge again as further technological advancements are reflected in lower UNE prices, even though neither the ILEC nor any competitor had implemented those advancements in its network.[9]

II. THE FCC'S METHODOLOGY IS NOT DEREGULATORY, CREATES ARTIFICIAL INCENTIVES, AND DISCOURAGES INVESTMENT, ALL IN DIRECT CONTRAVENTION OF THE ACT'S PURPOSES AND POLICY.

The FCC's TELRIC methodology also thwarts the Act's purposes and "frustrate[s] the policy that Congress sought to implement." *Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.*, 468 U.S. 137, 143 (1984) (internal quotations omitted); *see also John Hancock Mut. Life Ins.*

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[9] The statute's requirement that UNE rates be "just and reasonable" further cements the link between UNE rates and the ILEC's costs. Federal courts, including this Court, routinely have held that, to be "just and reasonable," rates must at least "enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed." *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 605 (1944); *see also Wisconsin v. FPC*, 303 F.2d 380, 388 (D.C. Cir. 1962) ("It is established by tradition and by many court decisions that for a public utility, rendering service by use of fixed equipment, a just and reasonable rate is one which returns a fair profit upon the investment, or which supplies the utility with adequate revenues to command needed funds upon an economically reasonable basis."), *aff'd*, 373 U.S. 294 (1963). By choosing a methodology that ensures ILECs will never recover their costs, the FCC has violated the settled meaning of the requirement that UNE prices be "just and reasonable." *Neder v. United States*, 527 U.S. 1, 21 (1999) ("[W]here Congress uses terms that have accumulated settled meaning under the common law, a court must infer, unless the statute otherwise dictates, that Congress means to incorporate the established meaning of these terms.") (internal quotation marks omitted).

Co. v. Harris Trust & Sav. Bank, 510 U.S. 86, 94-95 (1993) (agency construction must be consistent with statute's "object and policy"). Congress intended to deregulate local telecommunications and rely on market forces to encourage all participants to invest and innovate. Rather than encourage the development of an actual competitive *process*, the FCC prescribed prices it guessed would prevail in a perfectly competitive market in a theoretical world. In so doing, the FCC abandoned the deregulatory goals of the Act in favor of just another form of regulation that distorts the marketplace by deterring investment and facilities-based competition.

Congress intended sections 251 and 252 to serve the Act's objective of fostering a competitive marketplace. Ultimately, the statute is *deregulatory* in nature: Congress's objective was to create a competitive marketplace so that market forces would drive decisions about entry, investment, and pricing. *See, e.g.*, Conf. Rep. at 113 (Act creates a "deregulatory national policy framework"); J.A. 265 (Order ¶ 3) (Act is "deregulatory"). As the order itself observes, by passing the Act, Congress intended to "look to the market, not to regulation, for the answer." *Id.* at 271-72 (Order ¶ 12).

A critical part of Congress's deregulatory vision was to encourage investment in new facilities and technologies. As the FCC itself has recognized, a "fundamental goal of the Act is to promote investment and innovation by all participants in the telecommunications marketplace, and, in particular, to encourage rapid deployment of new telecommunications technologies." *UNE Remand Order*, 15 FCC Rcd at 3748, ¶ 110. Congress broadly mandated that "[t]he Commission and each State commission with regulatory jurisdiction over telecommunications services shall encourage the deployment on a reasonable and timely basis of advanced telecommunications capability to all Americans" and "take immediate action to accelerate deployment of such capability by removing barriers to infrastructure investment." 47 U.S.C. § 157 note.

Congress believed that such infrastructure investment would lead to facilities-based competition in the local telecommunications market. The premise of the Act is that local telephone service is not a natural monopoly and that facilities-based competition is therefore both possible and desirable. *See Iowa Utils Bd.*, 525 U.S. at 371; Conf. Rep. at 148 (endorsing view that "meaningful facilities-based competition is possible").[10] Indeed, facilities-based competition is clearly preferable to competition based on UNEs: "[C]ompetition [is] increased by encouraging [firms] to [develop rival facilities], rather than taking the easier and less competitive course of obtaining access to another's facilities." 3A Philip E. Areeda & Herbert Hovenkamp, *Antitrust Law* ¶ 773b2, at 203-04 (1996). As Justice Breyer observed, "[i]t is in the *un*shared, not in the shared, portions of the enterprise that meaningful competition would likely emerge." *Iowa Utils. Bd.*, 525 U.S. at 429 (Breyer, J., concurring in part and dissenting in part) (emphasis in original). Although the Act may not require the FCC to *favor* facilities-based competition over UNEs (and resale), at a minimum it requires that the FCC not erect artificial disincentives to that strategy. J.A. 271-72 (Order ¶ 12) ("Section 251 neither explicitly nor implicitly expresses a preference for one particular entry strategy.").

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10 *See also* Conf. Rep. at 1 (passage of the Act would "accelerate rapidly private sector deployment of advanced telecommunications and information technologies"); *Communications Law Reform: Hearings Before the Subcomm. on Telecommunications and Finance of the House Comm. on Commerce*, 104th Cong. 9 (1995) (the Act "rightly stresses a need for facilities-based competitors to lead the way in providing a true alternative to today's monopoly in the local exchange service. In fact, it is no exaggeration to say that the entire bill is premised on the existence of robust facilities-based competitors.") (statement of Rep. Schaefer); 141 Cong. Rec. 22,040 (1995) (the Act is intended to "give[] new entrants the incentive to build their own local facilities-based networks, rather than simply repackaging and reselling the local services of the local telephone company") (statement of Rep. Goodlatte).

A. The FCC's Order Distorts Entry and Investment Incentives by Relying on Regulation Rather than the Marketplace.

The FCC's order defeats Congress's goal of fostering a deregulated competitive marketplace in which entry and investment decisions are based on market signals. Instead, the order uses regulation to *simulate* a theoretically perfect market through regulation — that is, it prescribes rates at levels that the agency theorized would prevail in a nonexistent, perfectly competitive market without regard to whether its actions would encourage or impede the development of a competitive process. J.A. 379-80 (Order ¶ 679). As Justice Breyer explained in *Iowa Utilities Board*, such an approach — far from deregulatory — simply substitutes one form of regulation for another: "[t]he competition that the Act seeks is a process, not an end result; and a regulatory system that imposes through administrative mandate a set of prices that tries to mimic those that competition would have set does not thereby become any less a regulatory process, nor any the more a competitive one."[11] *Iowa Utils. Bd.*, 525 U.S. at 424

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11 The FCC itself recognized this very distinction in an order released less than a year after the order at issue here. The agency rejected calls by carriers such as AT&T and WorldCom to prescribe the level of access charges (charges paid by long distance carriers to LECs to originate and terminate long distance calls) on the basis of forward-looking costs:

> We decide that adopting a primarily market-based approach to reforming access charges will better serve the public interest than attempting immediately to prescribe new rates for all interstate access services based on the long-run incremental cost or forward-looking incremental cost of interstate access services. Competitive markets are superior mechanisms for protecting consumers by ensuring that goods and services are provided to consumers in the most efficient manner possible and at prices that reflect the cost of production. . . . In addition, using a market-based approach should minimize the potential that regulation will create and maintain distortions in the

(Breyer, J., concurring in part and dissenting in part). Indeed, because the FCC's TELRIC methodology discourages investment in network facilities, *see infra* Part II.B, its methodology actually is a barrier to the development of a real competitive marketplace.

In setting UNE prices based on the assumption of a theoretically perfect market, the FCC committed much the same error that infected its determination that the statutory "impair" test was met by any increase in cost. *See* J.A. 292 (Order ¶ 285). As this Court explained in reversing that determination, "[i]n a world of perfect competition, in which all carriers are providing their service at marginal cost, the Commission's total equating of increased cost . . . with 'necessity' and 'impairment' might be reasonable; *but it has not established the existence of such an ideal world.*" *Iowa Utils. Bd.*, 525 U.S. at 390 (emphasis added). Likewise here, although UNE prices might tend toward some measure of incremental costs *in a world of perfect competition*, that is not this world. *See* James C. Bonbright, Albert L. Danielsen & David R. Kamerschen, *Principles of Public Utility Rates* 146 (2d ed. 1988) ("*Public Utility Rates*") ("[T]he concept of perfect competition makes no sense whatsoever" as a pricing standard.).

Finally, the FCC's methodology makes a nullity of the voluntary negotiation provisions of the Act. The statute allows carriers to engage in good-faith, private negotiations "without regard" to the Act's requirements, including the provision concerning pricing of UNEs. 47 U.S.C. §§ 251(c)(1), 252(a)(1), 252(e)(2)(A). Only if the parties cannot reach agreement may regulators set UNE prices. *See id.* § 252(b). But negotiations over UNE rates under these

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investment decisions of competitors as they enter local telecommunications markets.

Access Charge Reform, First Report and Order, 12 FCC Rcd 15,982, 16,094, ¶ 263 (rel. May 16, 1997).

provisions are meaningless where the default price is set based on a hypothetical, idealized network and below any real-world price, as TELRIC mandates.

B. The Order Creates Disincentives to Investment by Both CLECs and ILECs.

The FCC's attempt to simulate a perfectly competitive market rather than foster an actual competitive process distorts market signals and suppresses the level of investment and innovation by ILECs and CLECs alike in direct contravention of Congress's intent.

1. In the case of CLECs, TELRIC discourages investment in at least three ways:

First, the methodology reduces the incentive of CLECs to invest, because, no matter how efficient, they by definition will never be able to invest at costs lower than the idealized TELRIC price for UNEs. Indeed, the order makes explicit that UNE prices should never exceed and "in most cases" will be below "the forward-looking cost that an efficient entrant would incur in providing a given element." J.A. 392 (Order ¶ 698); *see also* Alfred E. Kahn, *Letting Go: Deregulating the Process of Deregulation* 101 (1998) ("*Letting Go*") ("What is the point of a CLEC constructing its own facilities if it can lease or purchase them from the incumbent companies at the theoretically estimated *minimum* cost (let alone below that cost [as under TELRIC]) that would be incurred by a new entrant building from the ground up?").

The FCC's order gives CLECs the pricing benefits of cost-saving innovations where those innovations have not been implemented and costs have not actually declined. This mismatch between prices and costs distorts market signals and creates *disincentives* to the investment in facilities that actually would drive costs down to an efficient level:

> The economic purpose of prices set at incremental cost is to inform buyers — and make them pay —

> the cost that society will *actually* incur if they purchase more or would *actually* save if they reduced their purchases, entirely or partially. These can only be the costs of the supplier whose prices are being set, not some hypothetical ideal producer. Moreover, such prices give challengers the proper target at which to shoot — the proper standard to meet or beat and the proper reward if they succeed. If they can achieve costs lower than that, they will enter and *in the process* (which the FCC's pricing rules would omnisciently short-circuit) beat prices down to efficient levels. In contrast, TELRIC-based charges — if the FCC's apparent expectation that such rates would be lower than rates based on telephone companies' actual costs is correct — would actually discourage competitors coming in and building their own facilities . . . .

Alfred E. Kahn, Timothy Tardiff & Dennis L. Weisman, *The Telecommunications Act at three years: an economic evaluation of its implementation by the Federal Communications Commission*, 11 Info. Econ. & Pol'y 319, 330 (1999) ("*Economic Evaluation*") (emphasis in original).[12]

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[12] This same mismatch of prices and costs explains the infirmity of petitioners' suggestion that failure to price elements at TELRIC will permit incumbents to engage in a "price squeeze." *See* WorldCom Pet. Br. at 11, 40; AT&T Pet. Br. at 18, 32. According to petitioners, if CLECs must buy UNEs at prices above TELRIC, they will have to price their services above TELRIC prices in order to recover their full costs. In the meantime, petitioners posit, incumbents will price their services at TELRIC and therefore will be able to squeeze the CLECs out of the market. *See* WorldCom Pet. Br. at 11. But this argument assumes that carriers are operating in a perfectly competitive market in which prices are at marginal costs and that the incumbent or some other seller is an ideally efficient carrier whose costs actually equal TELRIC. Of course, that is not the case. As long as the CLEC obtains an element from the ILEC at or below the ILEC's costs (as opposed to the TELRIC costs of a hypothetical competitor), there is no possibility of a price squeeze: both the CLEC and the ILEC must recover the same costs for that element in the retail price for the service. Indeed, if anything, TELRIC pricing puts *ILECs* in a price squeeze. Because a CLEC can obtain an element (or indeed, under the FCC's order, all the elements needed to provide a service) at the costs that would be incurred by an ideally efficient competitor, the CLEC can price below the costs of the ILEC, who — as petitioners insist, *see* FCC Pet. Br. at 28-29; AT&T Pet. Br. at 4, 18, 19, 33 — is not ideally efficient.

The order's uncoupling of UNE prices from costs is evident also in its faulty analysis of a CLEC's entry decision. The FCC states that its methodology focuses on "factors relevant to any carrier's present choices in a competitive market with respect to entry, expansion, and pricing." FCC Pet. Br. at 21. The agency observes that, all other things being equal, if a more efficient and less costly facility is available as a substitute for an incumbent's element, a rational entrant will not pay more than the cost of that substitute facility for the element. *See id.* at 22-23, 29. But the FCC follows with a non sequitur: that the price for the incumbent's less efficient element should be set at the cost of the more efficient substitute, since that is all a rational entrant would pay. Of course, if in fact a more efficient alternative facility is available, CLEC investment in that facility — and not purchase of the less efficient incumbent UNE at an artificially low price — will promote the development of competition. The FCC's methodology, however, strongly discourages such an investment from being made.

Second, TELRIC deters investment in facilities because investing in current technology exposes a CLEC to the very real risk that the mere availability of a still newer technology will instantaneously be reflected in the incumbent's UNE prices and put its own facilities at a competitive disadvantage as compared to CLECs relying on UNEs. To the extent that a CLEC does consider investing to install even today's most efficient technology, the CLEC (like the incumbent) will realize that it would be unable to recoup the investment, because the prices of the incumbent's UNEs would immedi-

ately reflect tomorrow's further innovations, even if nobody had invested to install them. Of course, a competitor in a capital-intensive market with rapidly evolving technologies and declining costs always must weigh the risk of obsolescence against the potential gain in efficiency that investing in the current technology may bring. But, under TELRIC, CLECs can gain the benefit while entirely avoiding the risk of obsolescence by relying on UNEs and the automatic reduction of UNE prices to reflect every technological advance. In so doing, the CLEC purchasing UNEs will obtain an artificial regulatory advantage over a CLEC that invests in its own facilities.

Third, TELRIC pricing discourages CLEC investment because it artificially expands the list of UNEs to encompass facilities the CLEC could self-provision or obtain from third parties at costs that, while above TELRIC, are lower than the incumbent's costs. As originally written, the FCC's order deemed the statutory "impair" test to be satisfied by *any* increase in cost that the CLEC would incur if it did not have access to the element in question. J.A. 292 (¶ 285). Not surprisingly, having defined the price of a element to be equal to the cost that a hypothetical, ideally efficient carrier would incur, the FCC found this test to be satisfied by every element it examined. In *Iowa Utilities Board*, this Court held that the FCC's interpretation drained the "impair" test of any substance and accordingly directed the FCC to impose a rational limiting standard. 525 U.S. at 387-91. On remand, the FCC has indicated that the impair test is met when there is a "material" difference in cost. *See UNE Remand Order* at 3725, ¶ 51. Whatever that may mean, it is clear that, because UNEs are priced at the incremental cost of an ideally efficient competitor, self-provisioning (or obtaining elements from third parties) will be "materially" more costly than unbundling even in situations where the CLEC could build or

obtain an element more efficiently than the ILEC.[13] And once that element is made available for unbundling, the CLEC will have little incentive to self-provision instead of leasing the element from the incumbent at the cost of an ideally efficient carrier it could not hope to outcompete.[14]

2. TELRIC pricing also undercuts *incumbents'* incentives to invest and innovate. As two prominent economists have explained, "[u]nder the FCC's TELRIC price regulation, if a new service is successful, a competitor can buy the service at its total . . . long-run incremental cost . . . . For a successful new service, the ILEC recovers at most its cost. For unsuccessful services, the ILEC recovers nothing and loses its sunk investment." Jerry A. Hausman & J. Gregory Sidak, *A Consumer-Welfare Approach to the Mandatory Unbundling of Telecommunications Networks*, 109 Yale L.J. 417, 459-60 (1999). As a result, "the expected return to the ILEC [for research and development costs] would always be negative," and "regulation would completely eliminate the economic incentive to provide the new service." *Id.*; *see also Iowa Utils. Bd.*, 525 U.S. at 429 (Breyer, J., concurring in part and dissenting in part) ("Nor can one guarantee that firms will undertake the investment necessary to produce complex technological innovations knowing that any com-

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13 Indeed, with one exception, the FCC required unbundling of all the same elements as in its original order and then *expanded* the list to include additional elements. *See UNE Remand Order*, 15 FCC Rcd 3696 (rel. Nov. 5, 1999), *review pending*, *United States Telecom Ass'n v. FCC*, Nos. 00-1015 & 00-1025 (D.C. Cir.).

14 Of course, some CLECs have made substantial investments in facilities. But, as facilities-based CLECs told the FCC on remand from this Court, the FCC's unbundling rules, including TELRIC, suppress the amount of such investments. *See, e.g.*, Cox Communications Comments at 3, CC Dkt. No. 96-98 (May 26, 1999) ("A regulatory regime that fosters the broad availability of incrementally priced UNEs discourages competing carriers from building their own networks and leaves them dependent over the long term on the ILECs, to the detriment of the public interest.").

petitive advantage deriving from those innovations will be dissipated by the sharing requirement."); *Economic Evaluation* at 347-49 ("The notion that the ILECs are likely . . . to engage in . . . risky investments under a regulatory regime that requires them immediately to share those facilities with their competitors . . . at prices based on the FCC's efficient-firm cost standards is, quite simply, ludicrous.").[15]

In the end, even the FCC acknowledged the perverse investment incentives created by UNE prices based on a hypothetical, ideally efficient network. It conceded that such prices "discourage facilities-based competition by new entrants because new entrants can use the incumbent LEC's existing network based on the cost of a hypothetical least-cost, most efficient network" and therefore have little incentive to build their own facilities. J.A. 382-84 (Order ¶ 683). The FCC's "solution" was to make a single bow toward reality by adjusting its methodology so that the locations of incumbent's wire centers would be held constant. *See id.* at 383-84 (Order ¶ 685). This, the FCC said, will give CLECs an incentive to invest in facilities when and if they can use more efficient wire center locations. *See id.*

But the FCC failed to recognize the significance of this concession. It offered no explanation as to why it makes sense to encourage a CLEC to invest when it can choose a more efficient switch location than the ILEC, but not when it can be more efficient than the ILEC in any other way, whether by using a newer technology or by locating parts of

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15 To be sure, incumbents may not be required to unbundle "proprietary" elements unless the FCC finds access to such elements to be "necessary." 47 U.S.C. § 251(d)(2). However, many innovations and investments are not "proprietary" and, in any event, the FCC has already indicated an intention to override the statutory "necessary" standard whenever it decides (based on entirely unspecified criteria) "that the incumbent LEC's asserted proprietary interest is outweighed by the benefits of facilitating more rapid deployment of competition for the greatest number of consumers." *UNE Remand Order* at 3718-19, ¶ 37.

its network other than switches more efficiently than the ILEC. In point of fact, if a CLEC can build or locate any network element more efficiently than the competing ILEC has done, costs are reduced when the CLEC invests in that element rather than continuing to rely on the less efficient and more costly (even if favorably *priced*) ILEC element.

In sum, the FCC's rule requiring UNE prices to be based on the cost of a hypothetical, ideally efficient network cannot be reconciled with the Act, because the rule contravenes Congress's goals of creating a deregulated competitive marketplace and encouraging investment in facilities by CLECs and ILECs alike. Accordingly, the court of appeals' decision to vacate the rule should be affirmed.

III. THE FCC'S METHODOLOGY IS ARBITRARY AND CAPRICIOUS ON ITS OWN TERMS BECAUSE IT IS BASED ON ERRONEOUS ASSUMPTIONS THAT DO NOT REFLECT HOW REAL-WORLD MARKETS OPERATE.

The FCC's TELRIC methodology is unlawful also because, although it purports to simulate the results of a competitive market, TELRIC relies on unsupported and inaccurate assumptions that fail to mimic how a real-world competitive market operates. The FCC's TELRIC methodology assumes that, (1) as soon as a new cost-saving technology becomes available, (2) a carrier will immediately install that technology throughout its service region without regard to its previously installed facilities, and (3) immediately reduce its prices completely to its new lower incremental costs. None of these assumptions holds in a competitive market, particularly in one such as telecommunications that is capital intensive and characterized by rapid technological change and declining costs. By basing UNE prices on these flawed assumptions, the FCC's methodology ensures that the incumbent will forever be required to charge less than it invested in its facilities and never will recover the costs of even new (let alone historical) investments. *See, e.g.*, GTE Comments,

Hausman Aff. ¶ 14 n.4 ("[I]mprovements in technology will *always* guarantee that a totally new, hypothetical, network will have a theoretical lower cost than the actual network in place . . . . Thus, basing cost on the current most efficient technology will impart a downward bias on estimates of actual network costs, causing an economic loss to the LECs . . . .").

"Available" Technologies. Requiring UNE prices to be based on the most efficient technology that is "currently available," as TELRIC does, 47 C.F.R. § 51.505(b)(1), is contrary to how prices are set in a competitive market. The mere availability of a new technology, whether in a lab or even in the channels of commerce, is not sufficient to drive prices down in a real-world competitive marketplace. *See* J. Gregory Sidak & Daniel F. Spulber, *Givings, Takings and the Fallacy of Forward-Looking Costs*, 72 N.Y.U. L.J. 1068, 1142 (1997). Rather, a new technology affects prices only if at least one competitor has installed it (or certainly will do so in the near future) in sufficient quantities to supply a significant portion of the relevant market. Even AT&T's expert has grudgingly conceded that "in a competitive market the availability of a small amount of less-costly improved equipment does not immediately lead to an equivalent reduction in the affected prices" and that the FCC's TELRIC methodology therefore may require some "readjustment." William J. Baumol & Thomas W. Merrill, *Does the Constitution Require that We Kill the Competitive Goose? Pricing Local Phone Services to Rivals*, 73 N.Y.U. L. Rev. 1122, 1147 (1998); *see also* GTE Comments, Hausman Aff. ¶ 14 n.4 ("In a competitive market, a potential entrant could choose a new technology, but if the potential entrant decides not to enter, the hypothetical costs do not enter the pricing decisions," notwithstanding the availability of the new technology).

Ubiquitous and Immediate Deployment. The FCC's methodology also fails to reflect real-world markets because it bases, and lowers, UNE prices on the erroneous assumption that carriers operate in a perpetual greenfield. No carrier instantaneously installs a new network whenever a cost-saving innovation appears, as though it had no investment in existing facilities. Rather, even when a carrier decides to invest in a new technology, it generally does so incrementally, not ubiquitously throughout its network. For example, a carrier may use a new, more efficient loop technology first to extend service to a new neighborhood or development. But to assume (as the FCC's methodology does) that the carrier will simultaneously replace all existing loops in its network with the new technology belies reality. As Professor Kahn explains, TELRIC

> assume[s] in effect that the 'efficient firm' simply takes over the current volume of sales of the incumbent, sizing its plant to serve that demand at minimum cost. This assumption ignores the fact that many telecommunications assets are long-lived and that capacity is not deployed all at once, overnight, but expands incrementally to serve growing and changing demand. Ignoring the dynamic character of this process inherently understates the minimum costs of serving demand as it materializes in the real world, over time.

Economic Evaluation at 333-34; *see also* Baumol & Merrill, 73 N.Y.U. L. Rev. at 1147.

Firms systematically practice what economists term "anticipatory retardation." Rather than building a network from scratch to incorporate the newest technology the moment it becomes available, a firm invests in a new technology only when and where the cost of that technology is sufficiently below current prices that the firm can expect to earn a return on its investment in new assets over their economic lives. *See, e.g., Economic Evaluation* at 326. As a result, each carrier has capital plant of several vintages, with each vintage becoming outmoded over time as technological innovations permit lower costs. When the cost differential becomes suf-

ficiently great to justify making the investment needed to install a new technology in a particular location, the carrier does so and thereby achieves a cost advantage over other carriers whose plants have vintages that are in varying degrees less efficient than the new one.

Because no real-world carrier instantaneously installs a new technology throughout its network, the FCC's assumption of ubiquity artificially lowers UNE prices. Under the agency's methodology, each time the network is reconstructed to calculate UNE prices, the facilities hypothetically deployed have the perfect amount of capacity and are in the ideal locations given current and reasonably foreseeable demand. In the real world, of course, even efficient carriers do not have the benefit of such hindsight. They must project at the outset how much capacity they will need and where; then, if demand grows, they must increase capacity by, for example, adding modules to an existing switch — typically less efficient than buying a switch perfectly sized for the new output. *See* Bell Atlantic Reply Comments, Epstein Decl. ¶ 15 (TELRIC "imagines that in a competitive industry an efficient firm makes all the correct decisions on cost and design for the optimal network the first time out of the box, and has perfect foresight of how technology will develop. Stated in this form, the proposal offers a parody and not a description of a competitive industry.").

Moreover, the FCC's methodology posits a "bulk purchase" of the new facilities, when in fact carriers are likely to buy and install a new technology in much smaller increments with correspondingly higher costs (since they will not benefit from the same volume discounts). Finally, even when a new technology is installed, it lowers costs only in the particular location where the installation occurs. The airline industry illustrates this phenomenon. If a more efficient airline begins service on a route – say, from Richmond to Atlanta – and charges fares based on its lower costs, competitors may be forced to meet that reduced fare *on their Richmond to Atlanta*

flights. They are *not,* however, forced to match that fare throughout the rest of the country. Similarly, even in a fully competitive telecommunications market, if a carrier rolls out a new technology in a particular area, prices may begin to drop *in that area* (though, as discussed below, they will not fall to LRIC immediately), but not, as the FCC's TELRIC methodology assumes, everywhere at once.

Instantaneous Price Reduction. The FCC's methodology also erroneously assumes, again without explanation, the existence of a theoretically perfect market in which prices *immediately* reflect the full cost savings of a carrier's investment in a new lower-cost technology. But the opposite is true. A key incentive to install a new technology is to achieve a temporary cost advantage over competitors. *See, e.g., Economic Evaluation* at 348-49. As long as that cost advantage persists, the investing carrier can price sufficiently above its newly lowered costs to recoup its investment. When another carrier invests in a still newer and lower cost technology, the first carrier's cost advantage dissipates, and the second carrier achieves a cost advantage for a period of time (again pricing somewhere between the first carrier's costs and its own). *See, e.g.*, U S WEST Comments, Harris & Yao Aff. at 19, CC Dkt. No. 96-98 (May 16, 1996) ("[W]hat often occurs in competitive industries is that a production facility makes above average profits during its early years of operation, which decline over time until the firm is forced to upgrade or close down the production facility."). As this cycle of leapfrogging investment goes forward, each carrier has an opportunity to recoup its investments by pricing *above* its incremental costs, and thus has an incentive to invest. *See, e.g.*, William J. Baumol, Janusz A. Ordover, & Robert D. Willig, *Parity Pricing and Its Critics: A Necessary Condition for Efficiency in the Provision of Bottleneck Services to Competitors*, 14 Yale J. Reg. 145, 160 (1997) ("[F]or each firm in a competitive market, the market price will cover the incremental cost of its product, a competitive return on the cost outlay, and *a bonus exactly equal to any*

relative cost savings that the efficiency of the firm permits it to contribute." (emphasis added)); *see also Public Utility Rates* at 154-55.[16]

This cycle will tend to drive prices down over time in response to cost-reducing innovations, but prices will not, as the FCC's methodology assumes, continuously drop all the way to the costs of the most efficient installed technology, particularly in an industry marked by rapid innovation cycles. To the contrary, the ability to price above cost is a key inducement to innovation and investment: Just as patent and intellectual property laws recognize that exclusive rights in

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[16] To be sure, part of the return above incremental costs may represent recovery of joint and common costs not attributable to a particular service or element; and the FCC purports to permit states to make some provision for those costs. *See* J.A. 375-76, 377-78, 381-82, 390-91 (Order ¶¶ 672, 676, 682, 696). However, the recovery of such costs does not meet the need for some above-cost return to recoup an investment in new technology. Indeed, the FCC has asserted that joint and common costs in the case of unbundled elements (as distinguished from services) will be quite small. *See id.* at 378-79, 389-90 (Order ¶¶ 678, 695).

Moreover, the Order falls far short of ensuring that incumbents can recover joint and common costs. For example, it expressly forbids states to use so-called Ramsey pricing to allocate joint and common costs, under which costs are allocated in inverse proportion to demand elasticity so as to maximize the chance for recovery. *See id.* at 352-53, 390-91 (Order ¶¶ 645, 696). Economists generally accept the efficiency of Ramsey pricing, *see Iowa Utils. Bd.*, 525 U.S. at 426-27 (Breyer, J., concurring in part and dissenting in part); yet the FCC rejected it out of hand, J.A. 390-91 (Order ¶ 696). Indeed, even the Interstate Commerce Commission Coal Rate Guidelines, which the FCC holds up as a model, relied on the principle of Ramsey pricing. *Coal Rate Guidelines, Nationwide*, 1 I.C.C.2d 520, 526-27 (1985), *aff'd sub nom., Consolidated Rail Corp. v. United States*, 812 F.2d 1444 (3d Cir. 1987). Here, by contrast, the FCC actually approved the use of "reverse Ramsey pricing" for recovery of joint and common costs, which is both inefficient and almost certain not to permit full recovery. *See* J.A. 390-91 (Order ¶ 696); J. Gregory Sidak & Daniel F. Spulber, *The Tragedy of the Telecommons: Government Pricing of Unbundled Network Elements under the Telecommunications Act of 1996*, 97 Colum. L. Rev. 1081, 1109-10 (1997).

an innovation for a period of time are a necessary inducement for innovation, the market rewards innovation by giving an innovator the opportunity to price above its costs to make a return on the innovation:

> If prices did not adjust gradually, there would be no incentive to engage in research and development or to invest in costly manufacturing to introduce any generation of products bearing new technology. . . . [B]ecause of lags, companies earn a return on the current technology in the interim period before the new technology becomes available; after the new technology is introduced, the development cycle continues. To imagine that prices fall immediately as a new technology is spotted over the horizon would be to eliminate any incentives for R&D and investment in production.

Sidak & Spulber, 72 N.Y.U. L.J. at 1142; *see also Economic Evaluation* at 348.

In short, at least in a market such as telecommunications that is characterized by successive cost-reducing innovations, incremental costs drop iteratively, and prices lag behind. As a result, the FCC's supposition that prices always and instantaneously equal incremental costs in a competitive market is simply wrong. *See* Joseph A. Schumpeter, *Capitalism, Socialism and Democracy* 105 (3d ed. 1950) ("The introduction of new methods of production and new commodities is hardly conceivable with perfect — and perfectly prompt — competition from the start. And this means that the bulk of what we call economic progress is incompatible with it. As a matter of fact, perfect competition is and always has been temporarily suspended whenever anything new is being introduced . . . even in otherwise perfectly competitive conditions.").

At least one petitioner suggests that the FCC's model does not in practice assume that prices will instantly reflect

cost-saving technologies because interconnection contracts typically have three-year terms and so lock in prices for that period. *See* WorldCom Pet. Br. at 39. But this hardly corrects for the FCC's error. First, as noted, the FCC's methodology erroneously assumes that ILECs have incorporated the most efficient available technologies ubiquitously at the time the TELRIC methodology is employed. Second, an incumbent contracts with multiple CLECs at different times, and, under the FCC's methodology, the incumbent's network must be (figuratively) rebuilt every time. When this is coupled with the FCC's "pick and choose" rule, under which a CLEC can always opt into the favorable terms of another CLEC's subsequent interconnection agreement, *see* 47 C.F.R. § 51.809, the result is that technologies and prices are not locked in for the three-year term. Finally, even if TELRIC were applied only once every three years, it would still belie competitive reality, since no ILEC builds from a greenfield every three years.

The lack of connection between TELRIC and the operation of an actual market is further confirmed by the FCC's inability to point to any other instance in which a regulator has used the FCC's TELRIC methodology in similar circumstances — that is, to set prices in an environment marked by technological change in which the regulatory goal is not to *simulate* competition, but to *stimulate* competition by giving proper signals for investment. Petitioners note that incremental cost methodologies have been used by courts to set a price *floor* below which a price is deemed to be predatory for antitrust purposes. *See* AT&T Pet. Br. at 8, 29-30 (citing *MCI Communications Corp. v. AT&T*, 708 F.2d 1081, 1115-17, 1124-25 (7th Cir. 1983)); *see also* FCC Pet. Br. at 22. That makes perfect sense: a vendor would have little reason — other than predation — to price *below* its long run incremental costs, at least in a market (such as telecommunications) where incremental costs are generally decreasing. But to say that some measure of incremental cost represents a *floor* beneath which a party should not price does not justify

the use of incremental costs as a regulatory price *ceiling*.[17] Indeed, implicit in making LRIC a price floor is the recognition that in most situations competitors actually price *above* LRIC. As these cases recognize, when a party prices above LRIC, that creates an opportunity for a more efficient competitor to enter and undercut the incumbent. *See, e.g., MCI Corp.*, 708 F.2d at 1120. By mandating that UNE prices always be equal to TELRIC, the FCC creates a disincentive for such entry.

Petitioners also rely on a single instance in which the Interstate Commerce Commission used a LRIC-type methodology to set rates that could be charged to captive shippers for carrying coal by rail. *See* FCC Brief at 24 & n.9 (citing Ex Parte No. 347 (Sub-No. 1) *Coal Rate Guidelines, Nationwide*, 1 I.C.C.2d 520, 542-46 (1985), *aff'd sub nom. Consolidated Rail Corp. v. United States*, 812 F.2d 1444, 1451, 1457 (3d Cir. 1987)). That situation was critically different. In that proceeding, the shippers were captive and the regulatory goal was *not* to increase competition so that the shipper would have multiple choices. With competition unavailable, the second best solution was for the regulator to attempt to predict the price that the end user shipper would have to pay if the market were competitive. Here, by contrast, Congress's goal was to send appropriate market signals to encourage investment and entry by other carriers, so that no end user will be a captive and market forces will determine prices. Setting a price based on the hypothesized outcome in a perfectly competitive market with an ideally efficient car-

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[17] Petitioners' reliance on predatory pricing cases is misleading in another respect: far from reflecting a consensus in support of a methodology similar to the FCC's, predatory pricing cases and literature are rife with conflicting views on the appropriate measure of costs for establishing a price floor. *See, e.g., Barry Wright Corp. v. ITT Grinnell Corp.*, 724 F.2d 227, 231-32 (1st Cir. 1983); Phillip Areeda & Donald F. Turner, *Predatory Pricing and Related Practices Under Section 2 of the Sherman Act*, 88 Harv. L. Rev. 697 (1975).

rier is fundamentally contrary to that statutory purpose. Instead — as Congress prescribed — prices should be based on the incumbent's actual costs, so that others will enter the market and invest in facilities to the extent they can do so more efficiently.[18]

IV. THE ACT PERMITS THE FCC TO IMPLEMENT OTHER FORWARD-LOOKING METHODOLOGIES MORE CONSISTENT WITH THE STATUTORY PURPOSES.

The FCC and its supporters are simply wrong when they portray the agency as having a very limited number of extreme choices in setting UNE prices. In point of fact, the agency could have chosen a variety of pricing methodologies that were consistent with the Act. As Verizon argues, pricing on the basis of historical costs would satisfy the terms of the

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[18] LRIC-type methodologies have sometimes been used in the electricity industry. *See, e.g., Norwood v. FERC*, 962 F.2d 20, 21 (D.C. Cir. 1992); *Central Lincoln Peoples' Util. Dist. v. Johnson*, 735 F.2d 1101, 1116 (9th Cir. 1984); J. Robert Malko & Philip R. Swensen, *Pricing and the Electric Utility Industry* in *Public Utility Regulation: The Economic and Social Control of Industry* at 35-77 (1989). There, however, long run incremental costs generally are *increasing*. *See, e.g., Norwood*, 962 F.2d at 22; *Central Lincoln*, 735 F.2d at 1121-22. Thus, basing prices on a long run incremental cost methodology actually yields *greater* compensation to incumbents so that they can continue to invest and operate over the long run. The FCC and its allies suggest that it is unknown whether an ILEC's long run incremental costs will be higher or lower than its historic costs (that is, whether long run incremental costs are increasing or decreasing). *See, e.g.*, J.A. 398-99 (Order ¶ 705); Sprint Pet. Br. at 17. That is disingenuous at best. The FCC itself acknowledged in its order that historical costs are generally higher, as did commenters such as MCI; and petitioners' briefs are replete with assertions about the rapid pace of technological change in this industry. *See* J.A. 399-400 (Order ¶ 706); MCI Comments at 63, CC Dkt. No. 96-98 (May 16, 1996); AT&T Pet. Br. at 4, FCC Pet. Br. at 20. The lineup of the parties in this case leaves no doubt on this issue: CLECs would not be arguing for LRIC (and incumbents for historic costs) if they really thought historic costs were lower than LRIC.

statute. *See* Verizon Pet. Br. at 19-23. Moreover, contrary to the FCC's assertion that any attempt to measure an incumbent's own forward-looking costs amounts to an embedded cost methodology, *see* J.A. 383 (Order ¶ 684), the Act gives the agency discretion to consider other, more forward-looking techniques that avoid the infirmities of TELRIC.

As an initial matter, petitioners are wrong when they suggest that forward-looking costs must be either "long term," reflecting the time horizon at which all costs are variable, or "short term," taking all existing plant as fixed and including only variable costs, but nothing in between. J.A. 382-83 (Order ¶¶ 683-84); AT&T Pet. Br. at 17, 37-40; WorldCom Pet. Br. at 17. "Long term" and "short term" in this context are nothing more than the two ends of a continuum. *See* Alfred E. Kahn, *The Economics of Regulation: Principles and Institutions* 83-86 (1988). As economists recognize, "[i]n between these extreme cases, the very short and the very long run, there are all sorts of intermediate time periods in which the firm can make partial adjustments" so that some, but not all, costs that are fixed in the extreme short run become variable. William J. Baumol, *Economic Theory and Operations Analysis* 290 (4th ed. 1977); *see also Public Utility Rates* at 146-47, 423-24 ("[T]here is no point in assuming a greater degree of foresight than intelligent people can hope to enjoy at the time" of setting prices.).

The FCC could have calculated forward-looking costs over such an intermediate horizon (such as the three-or-four-year term of a typical arbitration agreement) and then included appropriate levels of fixed costs for any existing facilities that would remain in place during that time period and would be used to provide the element in question. *See, e.g., Public Utility Rates* at 423 (forward-looking incremental costs should be measured over "the next several years, from increases in rates of output to be accomplished by whatever plant additions and improvements will be warranted in view of the actual layout and actual capacity of the present plant").

In this manner, the UNE price would reflect the efficiency improvements and new technologies that the ILEC could expect to have in place and benefit from during the relevant future period; at the same time, the price would reflect the actual operational and depreciation expenses of the other facilities that would be used to provide the element. This would ensure that CLECs do not operate at a competitive disadvantage vis-a-vis the ILEC and would send appropriate economic signals: if a CLEC could provide the element more efficiently than the ILEC (taking into account the expected efficiency gains the ILEC would achieve during the term of the agreement on a forward-looking basis), the CLEC would have the proper incentive to invest in its own facilities.

The FCC also could have avoided at least some of the distorting effect of its methodology if it had truly relied on a Total *Element* LRIC approach, rather than what amounts to a Total *Network* LRIC methodology. In other words, when pricing an element, the relevant increment could be the total supply of the element in question, with the remainder of the network held constant, in the same way that the FCC held wire center locations, but nothing else, constant. This would, for example, recognize the reality that any existing service provider looking to invest in a new facility must take account of constraints imposed by its other facilities.[19]

The FCC could have chosen the efficient component pricing rule ("ECPR") methodology advocated by numerous economists. *See, e.g.*, Sidak & Spulber, 97 Colum. L. Rev. at 1093-99; Baumol, Ordover, & Willig, 14 Yale J. Reg. at 149-54. This forward-looking methodology is competitively neu-

[19] Consider, for example, a person considering the purchase of a word processing program. Suppose Word 8.0 is the most cost-efficient program in an abstract sense but requires Windows 2000 to operate, while Word 6.0 is less efficient but works with Windows 95. If the person has a computer with Windows 95 and will not replace it within the relevant time frame, the forward-looking cost for word processing should be the cost of Word 6.0.

tral and recognizes the economic reality that, in a real-world competitive market, the price for which a facility would be leased is based not only on its incremental costs but also on foregone opportunity costs. As Justice Breyer noted, "[t]he FCC rejected that system, but in doing so it did not claim, nor did its reasoning support the claim, that the use of such a system would be arbitrary or unreasonable." *Iowa Utils. Bd.*, 525 U.S. at 426 (concurring in part and dissenting in part); *see also* Sidak & Spulber, 97 Colum. L. Rev. at 1094-97 (explaining errors in FCC's discussion of ECPR).

The FCC also could have used a price cap model, as it and other agencies have done in other contexts. UNE prices would be based initially on historical costs or current prices but then reduced over time by an appropriate factor reflecting general improvements in productivity. *See Letting Go* at 95-96. Such an approach would give incumbents the incentive to innovate and invest, while at the same time giving CLECs reason to invest in their own facilities whenever they could provide the same element more efficiently than the incumbent (taking into account the reduction in price resulting from the productivity factor).

Neither the Act nor the court of appeals' decision requires the FCC to adopt any particular one of these or other possible approaches. Consideration of the alternatives is for the agency in the first instance. However, the FCC and its supporters are simply wrong in suggesting that the agency is faced with a limited choice between extreme approaches. The FCC remains free to consider methodologies that avoid frustrating the statutory purposes. But the FCC's choice of TELRIC is contrary to the Act and accordingly is unlawful.

CONCLUSION

This Court should affirm that part of the court of appeals' decision vacating the FCC's rule 51.505(b), which required UNE prices to be based on the costs of a hypothetical network "us[ing] the most efficient technology currently available and the lowest cost network configuration."

Respectfully submitted,

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